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STATE FOR SA/INS

MCC FOR SGROFF, DNASSIRY AND EBURKE

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TAGS: ECON EAID CE ECONOMICS
SUBJECT: SRI LANKA ECONOMIC UPDATE, AUGUST 2005

¶1. Summary: GDP growth slowed to 4.8 percent in the first quarter of 2005, against 6.4 percent for the same period in ¶2004. While the Central Bank says the growth momentum (to achieve growth over 5 percent) is continuing as expected, high inflation is a major worry. A recovery in agriculture and continued growth in exports, including garments and services, are expected to boost growth prospects in the coming months. Tourist arrivals are up, but the industry is unhappy as most of the tourists are budget travelers. Both imports and exports rose sharply in the first six months of 2005. The trade gap widened to $1.2 billion in 2005 from $1.1 billion in 2004. However, due to higher remittances, official inflows to the government in the wake of the December 26 tsunami and debt relief, official reserves have increased by about $200 million to around $2.4 billion in June 2005 from $2.2 billion in December ¶2004. Reflecting these developments, the rupee has appreciated by about 3.6 percent against the dollar, as of mid August. Political uncertainty, including constitutional challenges to the proposed tsunami aid sharing mechanism, the murder of the Foreign Minister, questions regarding the date of the next presidential elections, the withdrawal of a key Government coalition partner and the volatile security situation could also dampen growth. End Summary

4.8 Percent Growth in the First Quarter

¶2. GDP growth slowed to 4.8 percent in the first quarter of 2005, compared with 6.4 percent for the same period in ¶2004. The slowdown is primarily attributed to the tsunami damage. It has seriously affected fishing and tourism while dampening growth of banking, small industry, domestic trade and transport sub sectors. The industrial sector grew by 7 percent compared with 5.9 percent growth in 2004. Domestic agriculture recovered (as Sri Lanka recorded a bumper rice harvest), but due to heavy damages to fisheries, the agriculture sector growth was restricted to 0.5 percent. Services sector growth also slowed to 5.3 percent from 9.5 percent in 2004. Telecommunications sector remained robust, expanding by 35 percent. The tourism (hotels) sector recorded a drop of 40 percent. The banking sector recorded a marginal decline, due to rescheduling of loans granted to tsunami affected business as well as a narrowing of the

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interest rate spread.

¶3. The Central Bank is anticipating a further recovery in the economy during the rest of the year, with all three major sectors, agriculture, industry and services, contributing to growth. The economy is projected to register a growth rate of 5 to 5.5 percent in 2005. These projections are in line with IMF observations following Article IV consultations with Sri Lanka in early August. The IMF observed that the near term prospects for economic growth are positive-- with reconstruction and a strong performance in agriculture expected to offset adverse impact of tsunami damage. IMF, however, cautioned about several imbalances:
-- inflationary pressures due to reconstruction bottlenecks;
-- large fiscal deficits
-- high level of public debt
-- central Bank financing of the budget
-- high monetary expansion
-- the fiscal status of debt ridden state owned utilities.

Tourism not recovered

¶4. Tourist arrivals in the first seven months of 2005 were up 13 percent when compared to 2004. However, industry sources indicate that these numbers do not reflect the true status of the resort tourist market. Key growth segments in the post-tsunami period have been aid workers, visitors (mostly Indian) on short-term, shopping-targeted, highly discounted tour packages, and conference and business travelers. These travelers stay mostly in city hotels, which have consequently posted high occupancy levels (75 percent) during this period. Resort hotel occupancy, on the other hand, has averaged below 40 percent.

Inflation remains high

¶5. Average inflation was running at 12.7 percent in July. Despite high inflation, mainly due to higher oil prices, the Central Bank in its August monetary review left key interest rates unchanged, saying instead it would continue to conduct aggressive open market operations to curb inflation. The government also removed the Value Added Tax (VAT) on diesel, milk powder and cooking gas in order to reduce the impact of rising petroleum prices. The VAT reductions are aimed to help the suppliers recover costs. The Central Bank hopes these tax revisions would also help to stabilize prices. Previously, the Central Bank raised its benchmark interest rate twice in (in May and June) to help dampen inflation.

¶6. Nevertheless, money supply growth remains around 20 percent due to increased credit to both public sector and private sector (the GSL had earlier announced it would target 15 percent money supply growth for the year). Money supply growth is expected to moderate following an expected lag in the transmission of the effects of the rate hikes to the financial system.

External Sector

¶7. Sri Lanka?s exports in the first half of 2005 rose 11.5 percent to $2.9 billion. Imports were up 10.3 percent to $4.1 billion. Consequently, the trade deficit widened to $1.2 billion from $1.1 billion in 2004. Despite fears of market losses following abolition of the MFA, Sri Lanka?s apparel exports rose by about 9 percent to $1.08 billion in the first five months of 2005. Tea exports also rose by 7.7 percent to $307 million during this period. While tea production has risen this year, average tea prices at the Colombo tea auction have dropped quite sharply in June and July. The drop has been attributed to reduced demand from Europe, lower quality tea, and the appreciation of the Sri Lankan rupee. Detailed trade data for the first half of 2005 is not yet available. Due to higher remittances, official post-tsunami inflows to the government and debt relief, official reserves have increased by about $200 million to around $2.4 billion in June 2005 from $2.2 billion in December 2004. Reflecting these developments, the rupee has appreciated by about 3.6 percent against the dollar through mid-August.

Fiscal Operations

¶8. Recent tax (VAT) cuts on diesel, milk powder and liquefied petroleum gas are expected to cost over Rs 10 billion (USD 100 million) or about 0.5 percent of GDP. In addition, Government expenditure will also increase due to subsidies, particularly on petrol and diesel. As a result, the budget deficit is likely to exceed the pre-tsunami deficit target of 7.6 percent. Due to increases in VAT and import duty in 2004, government revenue rose by over 20 percent in the first five months of 2005.

Political Uncertainty

¶9. The withdrawal of the Janatha Vimukthi Peramuna (JVP) (a nationalist/Marxist party) from the Government, reducing it to minority status, legal problems confronting the Post Tsunami Operational Management Structure (P-TOMS - also

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known as the ?joint mechanism? - was to facilitate unspecified donor funding to the North and East, including the LTTE controlled areas, through a transparent mechanism involving GSL, LTTE and the foreign donors rather than channeling aid directly to the LTTE), the controversy over the date of the next presidential election, the August 12 assassination of the foreign minister, and the volatile security situation will affect the economic climate in the next few months. Yet, despite several of these uncertainties, Sri Lanka?s equity market boomed in early July when a major mobile operator raised Rs 8.5 billion ($85 million) through a public share issue. The share issue attracted heavy foreign interest, reflecting the investment potential for well run companies in rapidly growing sectors.

¶10. The assassination of the Foreign Minister also did not have a major negative impact on the stock market. On the first day of trading following the assassination, the All Share Price Index lost 17 points (0.88 percent) and capitalization was down by Rs 5.3 billion ($53 billion). There was no further erosion of indices since then and the market has stabilized at this level.

¶11. The JVP?s withdrawal from the Government may have strengthened the Government?s policy making abilities. For example, since the JVP withdrawal, the Cabinet has been able to approve a new restructuring plan for the Ceylon Electricity Board (CEB). The new plan replaces a

controversial proposal, which would have dismantled the CEB and formed several independent companies. The plan was opposed by the JVP and was later withdrawn due to threatened blackouts by JVP-led unions. The new plan does not have the approval of the JVP-led union either, but the Cabinet was able to approve it without dissent. The new plan proposes to form several subsidiary companies, still under the CEB, and also requires tariff revisions and the adoption of a least cost generation plan with heavy reliance on new coal plants as a total solution to the current CEB problems. CEB's major professional trade union, the CEB Engineers' Union, has given its approval to the new plan.

Entwistle